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DAVID E. JANSSEN
Chief Administrative Officer

January 28, 2004

To: Supervisor Don Knabe, Chairman
Supervisor Gloria Molina
Supervisor Yvonne Brathwaite Burke
Supervisor Zev Yaroslavsky
Supervisor Michael D. Antonovich

From: David E. Janssen
Chief Administrative Officer

PROPOSITION 57: THE STATE ECONOMIC RECOVERY BOND ACT

On January 13, 2004, your Board asked my office to review and report back on Proposition 57, The Economic Recovery Bond Act, which was approved by the Legislature and the Governor in December 2003. Proposition 57 is being submitted to the voters for approval in the March Primary election in accordance with Article XVI of the California Constitution. The Act would authorize the issuance of a bond of up to $15 billion to assist the State in dealing with an accumulated budget deficit of $26 billion, according to the Governor.

A similar deficit financing bond of $10.7 billion was approved by the Legislature as part of the FY 2003-04 Budget, but it is being challenged in court because it was not submitted to the voters. While the Economic Recovery Bond has been characterized by the Governor as a back-up for the deficit bond, the Legislative Analyst's (LAO) summary says that it would replace the earlier bond. The summary is attached.

While the two bonds are similar in that they are intended to allow the State to borrow billions of dollars to eliminate the deficit from prior years while spreading the cost over many years, they differ in a number of significant respects that affect both their short and long term cost. The earlier $10.7 billion bond was to be financed through a dedicated one-half cent of sales tax revenues, and would cost approximately $2.4 billion annually for 5 years. The new $15 billion bond is to be financed through a one-quarter cent of sales tax revenues, and will cost approximately $1.2 billion for 14 years unless funds are transferred from the Budget Stabilization Account authorized by

Proposition 58, a linked measure on the March ballot that would require balanced budgets and create a rainy-day reserve. Each proposition must be approved by the voters for the other measure to take effect. Proposition 58 is summarized in a separate report.

The FY 2004-05 Budget proposed by the Governor on January 9, 2004 assumes voter approval of the Economic Recovery Bond and utilizes $12.3 billion of the proceeds to solve 47 percent of the $26 billion accumulated deficit. If voters do not approve the Economic Recover Bond in March, the State would face a $26 billion deficit that may require a major tax increase, as well as additional budget cuts far beyond what has already been proposed by the Governor.

Given the heavy financial dependence of counties on State funding and the almost one-half billion dollar loss of funding that the County would suffer under the Governor's Budget, a revised State budget that addressed a $26 billion deficit would further reduce funding for the County. **Therefore, I recommend that the Board go on record in support of Proposition 57.**

DEJ:GK
MAL:JR:ib/hg

Attachment

c: Executive Officer, Board of Supervisors
County Counsel

Attachment

LAO 60 YEARS OF SERVICE | legislative analyst's office

December, 2003

Proposition 57

The Economic Recovery Bond Act

Background

California's Recent Budget Problems. California's General Fund budget supports a variety of programs, including public schools, higher education, health, social services, and prisons. The General Fund has experienced chronic shortfalls between revenues and expenditures since 2001-02, when the economic and stock market downturns caused state revenues to decline sharply. To deal with these shortfalls, policymakers have reduced program expenditures, raised revenues, and taken a variety of other measures. They have also engaged in various forms of borrowing from special funds, local governments, and private credit markets.

Deficit-Financing Bond. One of the key actions taken to deal with the projected current-year (2003-04) budget shortfall was the authorization of a $10.7 billion deficit-financing bond. The purpose of this bond was to "wipe the slate clean" and eliminate the cumulative budget deficit that would have existed at the end of 2002-03. This would allow the state to avoid the more severe budget actions that would have been necessary to eliminate the deficit all at once. The repayment of the currently authorized bond would be based on a multiple-step financing process (see shaded box for details). It would result in annual General Fund costs equivalent to one-half cent of the California's sales tax—or about $2.4 billion in 2004-05 and increasing moderately each year thereafter—until the bond is paid off (in about five years).

Repayment of Deficit Bonds

Existing $10.7 Billion Bond. The previously authorized deficit-financing bond was designed to be repaid through a multiple-step process that "freed up" a revenue stream dedicated solely to repayment of the bond. This involved:

- The diversion of a one-half cent portion of the sales tax from local governments to a special fund dedicated to the bond's repayment.
- A diversion of property taxes from school districts to local governments to offset their sales tax loss.
- Added state General Fund payments to school districts to replace their diverted property taxes.

As a result of these diversions, there is no net impact on local governments or school districts. The full cost of the bond's repayment is borne by the state's General Fund.

$15 Billion Proposition 57 Bond. Under this proposition, the bond repayment

> method described above would be the same, except that the amount of revenues diverted would be equivalent to one-quarter cent of the state sales tax instead of the one-half cent. The full cost of the bond would continue to be borne by the state's General Fund.

This deficit bond is currently being challenged in court and has not yet been issued. (In the meantime, the carryover 2002-03 deficit is being financed through short-term borrowing, which is due to be repaid in June 2004.)

Projected Shortfall in 2004-05. The state is facing another large budget shortfall in 2004-05, which we estimate will be in the general range of $15 billion. This estimate assumes that the currently authorized $10.7 billion deficit-financing bond is sold and that the carryover 2002-03 deficit is thereby taken off the books. Absent the bond proceeds from this sale, the budget shortfall would be much larger.

Proposal

This proposition puts before the voters authorization for the state to issue a bond of up to $15 billion to deal with its budget deficit. The bond authorized by this measure would be used *in place of* the deficit-financing bond authorized last year by the Legislature.

Repayment of Proposed Bond. The repayment of the bond would result in annual General Fund costs equivalent to *one-quarter* cent of California's sales tax revenues, compared to costs equivalent to one-half cent of sales tax revenues for the currently authorized bond. In addition, certain funds transferred to the state's Budget Stabilization Account (created in Proposition 58 on this ballot, if approved) would be used to accelerate the repayment of the bond. The measure includes a backup guarantee that if the sales tax revenues dedicated to the bond are insufficient to pay bond principal and interest in any year, the General Fund will make up the difference.

This measure would become effective only if Proposition 58 on this ballot is also approved by the voters.

Fiscal Effects

The fiscal effects of the proposed bond are summarized in Figure 1, and compared to the currently authorized deficit-financing bond. The proposed bond would result in near-term budgetary savings compared to the bond authorized in current law, but added annual costs over the longer term. Specifically:

Figure 1

Comparison of Bond Authorized in Proposition 57 With Previously Authorized Bond

	Proposition 57 Bond	Previously Authorized Deficit-Financing Bond
Bond Amount	$15 billion [a]	$10.7 billion
Annual General Fund Costs:		
• Annual costs related to sales tax diversion.	$1.2 billion [b]	$2.4 billion [b]
• Potential annual payments from Proposition 58 reserve.[c]	$425 million in 2006-07	—
	$900 million in 2007-08	—
	$1.45 billion in 2008-09[d]	—
Years to Pay Off Bond:		
• Using only sales tax revenues.	14	5
• Assuming maximum $5 billion contribution from Proposition 58 reserve.	9	—

[a] Net proceeds to the General Fund would likely be less, depending on reserve requirements and other factors.

[b] Costs are for 2004-05. Amounts would increase moderately annually thereafter.

[c] Based on LAO out-year revenue projections and assumes no suspensions of transfer to reserve.

[d] These amounts would increase moderately annually thereafter until cumulative total from reserve equals $5 billion.

Near-Term Savings. The proceeds from the proposed bond would be up to $4 billion more than from the currently authorized bond. This would provide the state with up to $4 billion in additional one-time funds to address its budget shortfall. The state would also realize near-term savings related to debt service on the bond. This is because the payments would be based on one-quarter cent of annual sales taxes instead of one-half cent. As a result, annual General Fund costs would be one-half of the currently authorized bond for the next few years.

Longer-Term Costs. The near-term savings would be offset by higher costs in the longer term. This is because the proposed bond would be larger ($15 billion versus $10.7 billion) and it would take longer to repay. As indicated in Figure 1, the proposed bond would likely take between 9 and 14 years to pay back, compared to a 5-year period for the currently authorized bond.

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